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SHADOW ECONOMY

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Crime and shadow economic activities are a fact of life around the world, and almost all societies engage in trying to control these activities through education, punishment, or prosecution. Gathering statistics about who is active in the shadow economy activities, the frequency with which underground activities occur and the magnitude of these activities, is crucial for making effective and efficient decisions regarding allocating resources in this area. Obviously it is difficult to get accurate information about underground or shadow economy activities because individuals engaged in these activities wish to remain unidentified. Hence, estimation of shadow economy activities can be considered as a scientific passion for knowing the unknowable.

These attempts at measurement are obviously problematic:

1) Since shadow economy activities are performed in such a way as to avoid any official detection.

Moreover, if you ask an academic, a public sector specialist, a policy or economic analyst, or a politician, what is going on in the shadow economy, and even just how big it is, you will get a wide range of answers.

2) In spite of this, there is growing concern over the phenomenon of the shadow economy, and there are several important reasons why politicians and public sector workers should be especially worried about the rise and growth of the shadow economy.

Among the most important of these are:

If an increase of the shadow economy is caused mainly by a rise in the overall tax and social security burden, this may lead to an erosion of the tax and social security bases and finally to a decrease in tax receipts, and thus to a further increase in the budget deficit or to a further increase of tax rates with the consequence of an additional increase in the shadow economy, and so on. Therefore, a growing shadow economy can be seen as a reaction by individuals who feel overburdened by state activities.

With a growing shadow economy, (economic) policy is based on erroneous “official” indicators (like unemployment, official labor force, income, consumption), or at least indicators that are inaccurate in magnitude. In such a situation, a prospering shadow economy may cause politicians severe difficulties because it provides unreliable official indicators, and the direction of intended policy measures may therefore be questionable.

On the one hand, a growing shadow economy may provide strong incentives to attract (domestic and foreign) workers away from the official economy. On the other hand, at least two-thirds of the income earned in the shadow economy is immediately spent in the official economy resulting in a considerable (positive) stimulating effect on the official economy.

Studies trying to measure the shadow economy first face the difficulty of defining it. For instance, one commonly used definition is the shadow economy includes all currently economic activities which contribute to the officially calculated (or observed) Gross National Product.

Defines it as “market-based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP.” As these definitions leave open a lot

of questions, Table 1 may be helpful for developing a better feeling for what could be a reasonable consensus definition of the legal and illegal underground or shadow economy.

Table: A Taxonomy of Types of Underground Economic Activities

Type of Activity	Monetary Transactions		Nonmonetary Transactions	
ILLEGAL ACTIVITIES	Trade in stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling, and fraud		Barter: drugs, stolen goods, smuggling etc. Produce or growing drugs for own use. Theft for own use.	
	Tax Evasion	Tax Avoidance	Tax Evasion	Tax Avoidance
LEGAL ACTIVITIES	Unreported income from self-employment; wages, salaries and assets from unreported work related to legal services and goods	Employee discounts, fringe benefits	Barter of legal services and goods	All do-it-yourself work and neighbor help

From Table it becomes clear that the shadow economy includes unreported income from the production of legal goods and services, either from monetary or barter transactions hence, all economic activities which would generally be taxable were they reported to the tax authorities. In general, a precise definition seems quite difficult, if not impossible, as “the shadow economy develops all the time according to the 'principle of running water': it adjusts to changes in taxes, to sanctions from the tax authorities and to general moral attitudes, etc.” (Mogensen, et al. 1995 p. 5).

There are many obstacles to be overcome in measuring the size of the shadow economy and analyzing its consequences for the official economy. In this paper, it is shown that although it is difficult to estimate the size of the shadow economy, it is not impossible. I have demonstrated that with various methods (e.g., the currency demand, the physical input measure, and the model approach), some insights can be provided into the size and development of the shadow economy of developing, transition, and the OECD countries. The general impression from the results of these methods is that, for all countries investigated, the shadow economy has reached a remarkably large size. There is another common finding that the size of the shadow economy in most transition and all investigated OECD countries has been growing over the recent decade. Furthermore, the results in this essay show that an increasing burden of taxation and social security payments, combined with rising state regulatory activities, are the major driving forces behind the size and growth of the shadow economy. According to some studies, a growing shadow economy has a negative impact on official GDP growth and is linked to the amount of corruption.

To conclude: shadow economies are a complex phenomenon, present to an important extent even in the most industrialized and developed economies. People engage in shadow economic activity for a variety of reasons; among the most important, as far as I can tell, are government actions, most notably taxation and regulation. Along with these considerations goes a third, no less important one: a government aiming to reduce shadow economic activity has to first and foremost analyze the complex and frequently contradictory relationships that are among the consequences of its own policy decisions.